Reviews - Writings in Accounting

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Writings in Accounting

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"ACCOUNTING FOR THE COST OF EQUITY", Robert N. Anthony, HARVARD BUSINESS REVIEW, Vol. 51, No. 6, November - December 1973.

The author presents a cogent argument for recognition in financial accounting reports of the cost of using equity capital. This is an adoption of the economics concept of interest which identifies all capital as a factor of production with interest as its accompanying cost. Anthony discusses the conceptual justification for such treatment, the practical problems involved in implementing it, and the benefits from and possible objections to the proposal. An expanded version of the article will be published by the A.A.A. in its *Studies in Accounting Research* series.

In brief, Anthony recommends combining the interest on borrowed capital with an implied interest on equity capital to obtain a weighted average cost of capital. This computed average represents the cost of capital to the enterprise and is to be used in all cost allocations. The cost of goods manufactured is to include an interest charge on the capital assets used in production, in the same manner as it now includes a depreciation charge on plant and equipment. The cost of self-constructed plant and equipment is to include the interest cost both on the capital assets used in production and on the capital that is restricted during the construction period. Interest cost is to be added to the cost of assets held in inventory for significantly long periods (e.g., standing timber and aging whiskey inventories). Any interest expense not assigned to specific cost objectives is to be treated as a general period expense. On the balance sheet, the annual interest cost of equity capital will be a credit to earnings or to a special account in the owner's equity section.

As contrasted with present accounting methods, this proposal would result in increased cost of sales, decreased net income, increased asset amounts, and division of credits to retained earnings into equity interest and net income. The net income so reported would be true "profit."

Theoretically, this plan can be justified under the entity and cost concepts. The entity concept views both creditors and investors as outsiders, and equity capital as merely one of several sources of funds. Investors will not provide funds for the enterprise unless they expect to receive a return, which is the cost to the enterprise of using equity capital. This is a cost as real as any other and it should be recognized as such.

Practically, implementation of the plan is feasible. The problems involved in measuring the cost of equity capital are no more difficult of solution than those resolved by the profession in measuring interest costs on such debt instruments as convertible bonds. The total cost of capital is being measured today, both explicitly and implicitly. Many decisions made in business are based on an evaluation of the cost of using equity capital. Selecting among capital investment opportunities, pricing, and the rating of division performance all involve such judgments. Regulatory agencies commonly use a total cost of capital in setting rates. Expanding such procedures to other areas would not be contrary to reason.

Why make such a proposal? The author believes that financial reports which recognize a cost for the use of equity capital would provide more realistic information for management and investors in the evaluation of performance. He also thinks they would provide a better foundation for public policy decisions in the areas of rate regulation, price controls, and defense contracts. By distinguishing between equity interest and net income, such reports would help counteract the erroneous ideas of the public as to the nature and amount of business profits. Anthony believes that these benefits outweigh the problems associated with making such a drastic change in accounting principles.

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"County Rivals Big Business in Financial Reporting," Roy Bergman and C. E. McVaney, THE AMERICAN CITY, Vol. 88, No. 12, Dec. 1973.

In the December 1973 issue of this publication (that many of our readers may not regularly read) there is an article of particular interest to accountants concerning financial reporting in the public sector. It indicates the improvements made under a system of unified accounting and financial reporting. Standards have been recommended under the Uniform Budget Procedures of the Municipal Financial Officers of America. What is of special interest is that in Colorado a state law requires uniform financial reporting with respect to all governmental units. Alexander Grant & Company was engaged to design and install a system for Jefferson County, Colorado. Information is computerized at the point a transaction is made and clerical effort is minimized. Account files are updated daily with information being fed to the County's Data Processing Department. Any interfund settlement accounts can be taken care of automatically, trial balances reflecting the county's financial conditions can be developed on demand, and annual closing of the accounting records is done automatically.

Reports issued under the system are compared with those issued in the private sector for corporate control purposes. Every department receives weekly or monthly financial reports; in addition, financial reports can be obtained from the computer any time a responsible officer requests them. Forecasts of budget and revenue figures are established in the computer files and the actual conditions can be compared with these forecasts.

According to this article, Jefferson County, Colorado has an effective financial control and reporting system.

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The Evolution of the Theories and Techniques of Standard Costs, Ellis Mast Sowell; The University of Alabama Press, University, Alabama, 1973; 540 Pages.

Even though much has been written about standard costs, this book is one of the few that traces the evolution of cost standards back to the Guild System of Old England. The development of the theories and techniques associated with the non-scientific predetermined cost estimates is discussed in relation to the early British industrial organization. Certain estimating procedures arose and grew into a body of predetermined techniques concurrently with the development of industry in England and America. By recording accounting data under the estimating method, differences between actual expenditures and predetermined values were disclosed. This created the forerunner of the standard cost variance, known as the Cost Estimate Variation, which applies to the difference between the actual cost figures and the estimated cost values.

The book discusses the contributions of early writers in the field of cost accounting. It was interesting to read the background of standard costs and to realize that many of these writers admitted that the industrial engineer rather than the accountant deserves the credit for initiating the standard cost idea. For many years the accountant had been auditing and preparing statements covering past events. On the other hand, the engineer had been planning and estimating projects for future time periods. The theme of standard cost was in close harmony with the engineer's habitual trend of thought but was in direct contrast with the accountant's line of practice. While the industrial engineer was developing time and motion studies, the exception principle and the incentive wage payment plans in the period 1885-1918, the cost accountant devised burden allocation schemes and methods for recording and presenting cost information to management.

The book emphasized that standard costs can be considered an American contribution to cost practices. This is due to the fact that certain concepts which influenced the development of standard costs were initiated by American industrial engineers. Other significant theories were prepared and refined by American cost accountants. In addition, G. Charter Harrison was a resident in the United States for 10 years before he published his significant contributions. Dr. Sowell has made a unique contribution to the history of the development of cost standards.

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GETTING ACQUAINTED WITH ACCOUNTING, by John L. Carey, Houghton Mifflin Company, Boston, Massachusetts, 1973, 156 pages, paperback.

There is no question about the need for a book such as Carey has developed which serves as a non-technical introduction to what accounting is all about. The book is, as Carey intended it to be, a simple introduction to the field of accounting so that the student or other interested party can obtain an idea of the dimensions of the field. Although Carey does have a bibliography, subdivided on a chapter-by-chapter basis, which serves as a guide for those who may want to pursue the subject further, he has written the book without any footnotes to identify his many interesting points. Perhaps those of us who have been in academia for many years have worked too often with too many footnotes, but it is this reviewer's opinion that more footnotes and documentation would add substance and credence to the important points the author is making.

As part of the evolutionary development of accounting, Carey also describes the evolutionary economic development of business. Again some more specific references concerning Gross National Product, numbers of industries, etc., would be an enlightening addition to the text.

Even those who are already working in the field of accountancy may find that Carey's brief overview of the field of accounting is interesting and informative. He places emphasis upon the historical development of this new profession and points to some specific problems in the field, such as proper evaluation in financial reporting and proper handling of erratic price level changes. A few illustrative accounting reports are presented with some discussion about the degree of estimation that enters into what looks like a precise financial report.

The author also presents a discussion of some specific areas of accounting work such as income tax accounting, managerial accounting, and auditing.

In his analysis of the future prospects Carey presents concepts of social accounting, human resource accounting, and the role of the computer. He concludes that there will be much work for accountants to do in the future and that the accountants efforts will no doubt encounter some degree of conflict as they progress.

In presenting this book to the student who is not yet familiar with the field, one may question whether the student will be interested in the historical development of accounting, the corporate form of business, or the specifics of business education. An approach that might be more appealing to students might be an emphasis on the current and the future circumstances, rather than the past. Although statistical data may be overdone, the usefulness of this book might have been increased if it had included some facts and figures in tabular form showing the number of people employed in accounting, their areas of specialization, and some schedule of salary ranges. Specific job titles and typical types of duties associated with them would be enlightening to the student. A rundown of qualifying exams and their requirements, including the newly established Management Accounting Certificate, would also have been valuable.

This book is certainly one that accountants should read to refresh their knowledge of the background and future direction of the profession. As Carey indicates, it is also important that people outside the profession obtain an understanding of the professional status of accounting. Unfortunately, free publicity is given to the dramative negative factors; it is certainly encumbent upon the members of the profession to bring a balancing message to those unfamiliar with the positive aspects of the field.

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